



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Number: **201246038**
Release Date: 11/16/2012

Date: August 22, 2012

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

UIL: 501.12-01

Dear :

This is our final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code section 501(a) as an organization described in Code section 501(c)(12).

We made this determination for the following reason(s):

You are not organized and operated as a cooperative under I.R.C. § 501(c)(12). Your Articles of Incorporation are not written to comply with I.R.C. § 501(c)(12), you are not democratically controlled by your members, your members' rights and interests are not determined in proportion to their business with you, you retain funds in excess of expenses but do not describe the use of this reserve, and you failed to provide adequate records to determine each members' rights and interest in the funds you maintain. Furthermore, you do not perform the activities of a mutual ditch or irrigation company under I.R.C. § 501(c)(12). Finally, you failed to show that 85 percent of your income is received from your members for the sole purpose of meeting income and expenses. Based upon a review of the materials you submitted you are not described in I.R.C. § 501(c)(12).

You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the

instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Lois G. Lerner
Director, Exempt Organizations

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: May 11, 2012

Contact Person:

Identification Number:

LEGEND:

You(r)/Applicant:

State:

Date 1:

Date 2:

Department:

X:

Y:

Dear :

We have considered your application for recognition of exemption from Federal income tax under Internal Revenue Code § 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under I.R.C. § 501(c)(12). The basis for our conclusion is set forth below.

I. FACTS

You were organized as a nonprofit corporation under the laws of State on Date 1. Your Articles state that you are "organized exclusively for charitable, educational, and scientific purposes, including, for such purposes, the making of distributions to organizations that qualify as exempt organizations under" I.R.C. § 501(c)(3). Specifically, you were formed "to provide a means of local representation on a statewide basis regarding policies and activities dealing with reservoir storage and delivery within the [State]." You describe yourself as "a support organization for mutual ditch and irrigation companies in [State]." You filed Form 1024, Application for Recognition of Exemption under Section 501(a), on Date 2 for recognition as an I.R.C. § 501(c)(12) mutual ditch or irrigation company or "like" organization.

Activities

You hold one conference/workshop every year. The purpose of this two day workshop is to increase awareness of dam and canal safety, construction, and technology. The first day is a "field trip" to a dam or canal near the conference site. The second day is a workshop on topics

such as dam engineering, construction, operation, maintenance, rehabilitation, and safety; vegetation control; project management; and technological advances.

You publish a newsletter three to four times a year that includes stories about dam canal repair and operation, maintenance tips, and grant applications deadlines.

You intend to conduct focus groups on various topics, including whether recreational users should share the costs of dam operation and about how problems should be resolved with the forest service. You provide no indication whether any focus groups have been conducted or are planned for the future.

You also intend to perform some lobbying, but you fail to describe these activities.

Cooperative Structure

You have four membership classes: two voting classes and two non-voting. The voting classes include individuals or associations that own or operate private, municipal, or county water storage or delivery systems. Yearly membership dues for individuals are \$x, which includes attendance for one individual at the annual workshop and one vote. Yearly membership dues for associations are \$3x, which includes registration for three representatives and three votes. Voting members establish policy by resolution, amend the Bylaws, and conduct other business at the annual meeting.

The non-voting classes, called "affiliate members" and "sustaining affiliate members," include individuals or representatives from private firms, corporations, or agencies with an interest in water storage and delivery systems. These members do not own or operate such systems. Yearly membership dues for affiliate members are \$2x, which includes attendance for one individual at the annual workshop but no voting rights. Yearly dues for sustaining affiliate members are \$12x, which includes attendance for three and a booth for display of products at the annual workshop but no voting rights.

Failure to pay membership dues results in the member, whether voting or non-voting, being "dropped from the membership and the list of members."

Currently, 100 percent of your income is from membership dues paid by all four membership classes. You do not specify how much income is derived from each class. Additionally, Department has agreed to contribute up to \$y for expenses related to your annual workshop. This amount will be paid directly to the annual workshop's host. Your yearly expenses are approximately half the amount received from membership dues. The rights and interests of your members in your annual savings are not determined in proportion to their business with you. You therefore do not keep the records necessary to determine at any time each member's rights and interests in such savings, including assets acquired with the savings. Furthermore, you do not intend to make distributions of surplus funds to your members.

Upon dissolution, you distribute any gains from the sale of an appreciated asset "for one or more exempt purposes within the meaning of section 501(c)(3)."

II. LAW

I.R.C. § 501(c)(12) provides for the exemption of benevolent life insurance companies of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations, but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Treas. Reg. § 1.501(c)(12)-1(a) states that an organization described in I.R.C. § 501(c)(12) must receive at least 85 percent of its income from amounts collected from members for the sole purposes of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

Rev. Rul. 68-564, 1968-2 C.B. 221, determined that a mutual company, whose members were the owners of river front property, formed to contract with the Federal Government to prevent erosion of river banks qualified for exemption under I.R.C. § 501(c)(12) as a "like organization." The term "like organization" as used in this section applies to organizations that are similar to any one of the types of organizations specified in that section. Therefore, the mutual company was "like" a mutual ditch or irrigation company because the construction and maintenance of improvements that protected the river banks from damage or destruction by erosion preserved the usefulness of the members' surrounding lands in the same way that the furnishing of water by mutual ditch or irrigation companies enables their members to reclaim and preserve land for useful purposes.

Rev. Rul. 72-36, 1972-1 C.B. 151, sets forth certain requirements cooperative companies must meet for exemption under I.R.C. § 501(c)(12).

1. The rights and interests of the members in the savings of an organization should be determined in proportion to their business with the organization. The interests of members in the savings of the organization may be determined in proportion to either the value or the quantity of the services purchased from the organization, provided such basis is realistic in terms of actual cost of the services to the organization.
2. Funds retained in excess of those currently needed for such purposes as retiring indebtedness incurred in acquiring assets, expanding the services of the organization, or maintaining reserves for necessary purposes must be reasonable in light of the organization's business needs. Whether there is an improper accumulation of funds depends upon the particular circumstances of each case.
3. The organization's records must show each member's rights and interests in the funds it retains.
4. A member's rights and interest cannot be forfeited upon dissolution or termination.

5. Upon dissolution, gains from the sale of an appreciated asset should be distributed to all persons who were members during the period which the asset was owned by the organization in proportion to the amount of business done by such members during that period, insofar as is practicable.

Rev. Rul. 81-109, 1981-1 C.B. 347, determined that a mutual ditch company that operated in a traditional manner consistent with the provisions of a particular state statute may qualify for exemption under I.R.C. § 501(c)(12) even though it does not satisfy the requirements of Rev. Rul. 72-36, *supra*. The mutual ditch company in question was created in 1874 to maintain and operate an irrigation system for the use and benefit of its members. Membership was obtained through the purchase of stock that entitled the holder to certain water rights and the services of the organization. The shares of stock were assessable to provide funds to operate and maintain the irrigation system. If a member failed to pay the assessment, a lien was placed on the stock that could be collected through a forced sale of the stock. The member's interest in the organization would then be extinguished and the former member would have no claim on the organization's assets upon dissolution or otherwise. Furthermore, upon dissolution, only current members would receive a distribution of the company's gains. The mutual ditch company's operations were consistent with state law but not with Rev. Rul. 72-36, *supra*. The Service noted that the organization was created prior to the enactment of the earliest tax legislation pertaining to mutual ditch and irrigation companies and had continued to operate in a traditional manner since that time. The lack of changes in the applicable federal law indicated Congress' intent that mutual ditch and irrigation companies operated in the manner and under the circumstances described above would qualify for exemption under I.R.C. § 501(c)(12).

In Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3, the Tax Court stated that an organization must meet certain common law requirements in order to be a cooperative, which include: (1) democratic control of the organization by members; (2) operation at cost for the benefit of the members; and (3) the subordination of capital.

In Lake Petersburg Association v. Commissioner, 33 T.C.M. (CCH) 259 (1974), the Tax Court held, among other things, that the Lake Petersburg Association was not tax-exempt under I.R.C. §§ 501(c)(4), (5), (6), (7), or (12). The Association was formed, in part, to own, construct, maintain, and control a lake and its adjacent recreational facilities. The Service determined that the Association had income tax deficiencies in the years spanning from 1962 to 1967. As part of its defense, the Association argued that it was exempt from taxation under I.R.C. § 501(a). Specifically, the Association argued that it was exempt under I.R.C. § 501(c)(12) as an organization like a mutual ditch or irrigation company. The court rejected this argument because "[t]he purpose and operation of these two types of organizations are clearly different."

III. RATIONALE

An organization seeking exemption under I.R.C. § 501(c)(12) must satisfy three requirements. First, it must be organized and operated as a cooperative (the "organizational and operational tests"). Second, it must conduct activities described in I.R.C. § 501(c)(12) (the "activities test"). Finally, it must derive at least 85 percent of its income from members solely for the sole purpose of meeting expenses and losses (the "income source test"). The materials you submitted state that you are seeking recognition as an I.R.C. § 501(c)(12) as a mutual ditch or irrigation company or "like" organization. Based upon a review of your application, you are not described in I.R.C. § 501(c)(12) as explained below.

1. Organizational and Operational Test

An organization meets the requirements of the organizational and operational tests if it is organized and operated under both the common law definition and the requirements of Rev. Rul. 72-36, 1972-1 C.B. 151. Under the common law, a cooperative organization exhibits three characteristics: (1) democratic control by the members; (2) operation at cost; and (3) subordination of capital. Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 308 (1965), acq. 1966-1 C.B. 3. Additionally, a cooperative organization must meet the five requirements of Rev. Rul. 72-36, 1972-1 C.B. 151.

You do not meet the requirements of the organizational test. Your Articles are written to comply with I.R.C. § 501(c)(3), not I.R.C. § 501(c)(12). As such, your Articles exhibit none of the cooperative principles. Furthermore, your Articles do not contain any of the statements required by Rev. Rul. 72-36.

You also do not meet the requirements of the operational test. You are not democratically controlled by your members; only half of your membership classes have the right to vote, and, of those classes, one receives more votes than the other. Additionally, you do not operate according to the requirements of Rev. Rul. 72-36. First, your members' rights and interests are not determined in proportion to their business with you. Rather, membership dues are determined based on the member's commercial nature and ownership interest. Second, you retain funds in excess of your expenses, but you do not indicate whether funds kept in excess of those needed to meet current losses and expenses are kept solely to meet future losses and expenses. Third, you fail to provide evidence of record keeping adequate to determine each member's rights and interests in the funds retained. Fourth, members' rights and interests may be forfeited. Finally, upon dissolution, you distribute any gains from the sale of an appreciated asset "for one or more exempt purposes within the meaning of section 501(c)(3)" rather than to your members in proportion to the amount of business done by such members during the period you owned that asset.

You would be relieved of the need to meet the last two requirements of Rev. Rul. 72-36 if you were a mutual ditch company operated in the traditional manner consistent with the provisions of State law. Rev. Rul. 81-109, 1981-1 C.B. 347. However, you are organized as a nonprofit corporation under State law, not as a mutual ditch company. Therefore, you are neither organized nor operated as an I.R.C. § 501(c)(12) organization.

2. Activities Test

Second, you do not perform the activities of a mutual ditch company or "like" organization under I.R.C. § 501(c)(12). Rev. Rul. 81-109, 1981-1 C.B. 347, describes a "traditional" ditch and irrigation company as an organization created to maintain and operate an irrigation system for the use and benefit of its members. You "act as a support organization for mutual ditch and irrigation companies in [State]," not as a mutual ditch and irrigation company itself. Thus, you do not qualify as a mutual ditch or irrigation company under I.R.C. § 501(c)(12) because you do not operate as such.

The term "like organizations" applies to organizations that are similar to any one of the types of organizations specified in that section. See Lake Petersburg Assoc. v. Comm'r., 33 T.C.M. (CCH) 259 (1974) (determining that a recreational lake association was not "like" a mutual ditch

or irrigation company because "[t]he purposes and operation of these two types of organizations [were] clearly different"). For example, Rev. Rul. 68-564, 1968-2 C.B. 221, determined that a mutual company, whose members were the owner of a river front property, formed to contract with the Federal Government to prevent erosion of river banks qualified for exemption as a "like organization" under I.R.C. § 501(c)(3). This company was "like" mutual ditch or irrigation company because the construction and maintenance of improvements that protect river banks from damage or destruction by erosion preserves the usefulness of the members' surrounding lands in the same way that the furnishing of water by mutual ditch or irrigation companies enables their members to reclaim and preserve land for useful purposes. However, your activities are not like those of a mutual ditch or irrigation company. Therefore, you fail to meet the requirements of the activities test under I.R.C. § 501(c)(12).

3. Income Source Test

Finally, you failed to show that 85 percent of your income is received from your members for the sole purpose of meeting income and expenses. A "member" is an individual who has the right to elect the governing board of the cooperative and be involved in the operations of the organization. Puget Sound Plywood, 44 T.C. at 308. Only two of your four membership classes are "members" within the meaning of I.R.C. § 501(c)(12). You fail to state what percentage of your income comes from each class. Furthermore, your funds may be retained for any purpose, not for the sole purpose of meeting losses and expenses. Therefore, you fail to prove that you meet the requirements of the income source test.

CONCLUSION

Based on the foregoing, you do not qualify as an I.R.C. § 501(c)(12) organization. You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

Your protest statement should be accompanied by the following declaration:

Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and, to the best of my knowledge and belief, the statement contains all the relevant facts, and such facts are true, correct, and complete.

This declaration must be signed by an elected officer, a member of the board of directors, or a trustee rather than an attorney or accountant.

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to this address:

Internal Revenue Service
TE/GE (SE:T:EO:RA:T3)
1111 Constitution Ave, N.W.
Washington, DC 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Lois G. Lerner
Director, Exempt Organizations